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RANGES FOR 1990 AND 1991
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At this meeting, the FOMC is required to reconsider its monetary and debt ranges for 1990 and to set ranges for 1991 on a provisional basis. One objective of this exercise is to give the Federal Reserve an opportunity to communicate to the Congress and the public something more about its longer-run strategy and objectives than is found in the regular directive and policy record. Unfortunately, the massive restructuring of credit flows and accompanying displacement of deposits has made it more difficult than usual to use the specified variables in the Humphrey Hawkins Act--money and credit--to signal the Committee's intentions, as well as to add an element of discipline to the conduct of policy.

Nonetheless decisions about the ranges and the accompanying explanation can not be entirely divorced from strategic considerations. To assist the Committee in considering its choices, the bluebook on page 9 presented three alternative longer-run paths for monetary policy.

In a fundamental sense, the underlying situation facing monetary policy has not changed for a couple of years, though the risks may have shifted over time. The economy has been operating at levels of resource utilization that, at the least, appear inconsistent with moderating inflation, and that may hold the potential for gradually intensifying pressures on costs and prices. Given this starting point, as can be seen in the baseline simulation, growth of the economy below the rate of increase of its potential probably will be an inevitable aspect of a policy that makes even modest progress in bringing down the rate of inflation. Absent a marked improvement in the credibility of our pursuit of a price stability objective, substantial progress against inflation, as under the tighter strategy II, would in turn require an appreciable shortfall in growth; an easier policy that keeps the unemployment rate from rising significantly, strategy III, implies no lower inflation and some tendency for it to rise.

These strategies are indexed by differences in money growth, but they can be thought of more generally as different approaches to policy choices. The Committee has stated its intention to avoid both recession and accelerating inflation over the intermediate term--while seeking price stability over the long haul. In the context of executing policy under uncertainty, the baseline strategy, in effect, describes the results of putting about equal weights on the intermediate-term output and inflation objectives. The tighter strategy II can be seen as a policy in which the Committee puts more weight on insuring attainment of its inflation objective than avoiding a temporary shortfall in the economy, so that over the simulation period it tends to get both less inflation and less output. Strategy III is more consistent with a policy that tends to resist promptly tendencies for the economy to weaken appreciably, with the result that output is kept higher for a time, but so is inflation.

From this perspective, the difficulty of executing something like strategy II may have increased in recent years, because the room for maneuver between higher inflation and recession has shrunk. This is partly a consequence of the starting point around the economy's potential, and partly owing to this year's slowing of labor force growth, which, if sustained, would lower potential growth of output itself. In these circumstances a policy that tends to lean against inflation will more likely end up with recession. And one that leans away from recession will more likely end up with higher inflation.

The policy actions in terms of interest rates and money growth to implement any of these strategies depend on the strength of the underlying demands on the economy. The paths for money, interest rates and exchange rates behind the strategies in the bluebook are derived from the the assessment of these forces behind the greenbook forecast, which comprises the first few years of the baseline strategy. As Mike and Ted noted, that forecast now encompasses essentially no change in interest or exchange rates over the next few years. Thus strategy II implies some rise in interest and exchange rates over the near term--with the federal funds rate about a half percent higher in the first quarter of 1991 and the weighted average exchange rate 1 percent higher--while strategy III implies a similar drop in interest and exchange rates.

The monetary growth rates consistent with each strategy are particularly uncertain at this time. To the usual questions concerning underlying conditions in the economy, the effects of the thrift restructuring and other disturbances to depository intermediaries are adding a larger-than-usual dollop of doubt about the relationship between money and spending and prices. As discussed in the memo sent to the Committee, growth in M2 as well as in M3 in the second quarter was substantially slower than we had expected just a few months ago. To some extent the shortfall in money growth reflected weaker growth in spending than had been anticipated. But most seemed to stem from the sharp pickup in thrift restructuring associated with a much more active RTC, transferring deposits to banks and taking assets onto its own balance sheet. The deposit transfers themselves do not affect M2, but in the context of moderate expansion of bank assets--despite picking up substantial volumes of cash and assets from RTC--and virtually no net asset growth at solvent thrifts, the potential flow of M2 deposits was more than was needed. In these circumstances, depositories saw a chance to enhance their profitability while retaining a sufficient deposit base by maintaining unusually low deposit rates relative to Treasury yields. A portion of the M2 shortfall cannot be accounted for in our M2 models in terms of nominal income and average deposit rates. But it may reflect the large volume of so-called hot money in thrifts that neither banks nor thrifts wanted and could be dislodged from M2 by a very marginal fall in offering rates. With heavy RTC activity expected to continue, and a large volume of brokered funds remaining at thrifts, we have carried the shortfall forward, and also the behavior pattern that produced it, so we see continued, though diminishing, upward shifts in M2 velocity through the end of 1992. Given this analysis, we are anticipating M2 growth of only 3-1/2 percent in 1990 and 4-1/2 percent in 1991 consistent with the greenbook forecast.

The level of RTC activity and continued pressure on marginally solvent S&Ls are expected to produce substantial declines in thrift balance sheets through 1991. Banks also are anticipated to be under continuing pressures on their capital positions, and are poorly positioned to take up the slack. Consequently, we are projecting a very modest increase in depository assets and very little growth in M3--on the order of 1 and 1-1/2 percent in 1990 and 1991, respectively.

In light of the apparent shift in the quantity of M2 associated with a given path for market interest rates and income, the Committee could consider a downward adjustment of the M2 range for 1990. One such alternative--a range of 2 to 6 percent--is shown on p.17 of the bluebook. Although we are not predicting it, M2 could well fall short of its current range for reasons unrelated to a weak economy, and the FOMC might not want to foster expectations that such a shortfall would trigger easing actions. A shift in the M2 range could be explained as a technical adjustment, and would not be without precedent: in 1983 and 1985 the M1 range was adjusted at mid-year to take account of what was perceived to be aberrant velocity behavior.

On the other hand, there are strong arguments for leaving the range alone. M2 is still within its range, and is expected to remain there under the staff forecast. The 4-point range already should allow, to some extent, for the sort of unusual behavior we may be witnessing. Moreover, as noted earlier, some of the weakness is related to the economy and to reduced credit supplies holding down offering rates, and if there were thought to be significant downside risks to the outlook, the Committee might want to operate under the presumption that M2 growth below 3 percent would warrant a policy response, unless the further velocity shift clearly was even larger than anticipated. In the context of current concerns about the pace of economic expansion, lowering the range on technical grounds might be misunderstood, and retaining it might provide at least symbolic assurance that the Federal Reserve did stand ready to counter cumulative economic weakness.

M3 is not expected to come in within the range. This aggregate is now at the lower bound of its parallel band, and, barring a sudden cessation of RTC activity or burst of bank lending, is highly unlikely to grow at the 4-1/2 percent rate needed to put it within its cone by the fourth quarter. For this aggregate, much more than for M2, some action would seem to be needed, if only an announcement that we expected M3 to fall short of the range. A downward adjustment to the range, such as to the 0 to 4 percent alternative on p.17, could be explained as a technical adjustment made in response to the effects of thrift resolutions--which the Committee had flagged, but did not anticipate to the full extent. The adjustment can be explained as technical, because the M3 shortfall, for the most part, does not seem to indicate a meaningful change in credit availability. Most of the assets sold or removed from thrifts wind up on the balance sheet of the government or are easily securitized and sold to non-depository lenders with little effect on the terms of residential mortgage credit and spending. As a consequence, smaller volumes of M3 can support a given level of spending--the upward shift in M3 velocity.

The same reasons could be advanced for M3 falling short of its existing range should the Committee decide to retain the range and explain the shortfall. Not moving the range would avoid misinterpretation that the Federal Reserve was tightening. It would also avoid any sense that the Committee had enough confidence in its understanding of the forces at work to draw a new range that might have some weight in policy.

But, accepting an unspecified shortfall from the range risks giving the impression that the Committee was indifferent to developments in credit flows. That issue could be dealt with in the discussion of the debt aggregate, assuming the Committee would not alter its range for 1990. Consideration might be given to paying a little more attention to this aggregate and its range, given the concerns about conditions in credit markets and the availability of sufficient credit at terms that will permit continued economic expansion.

With regard to 1991, the bluebook on p. 19 gives two possible alternatives. Last July, the Committee simply carried forward its ranges for 1989 into 1990 on a provisional basis, on the grounds that the uncertainties in the financial system and economy were too large to permit judgment in July of appropriate ranges for the upcoming year. Then last February, when the picture for the current year was a little clearer, the Committee made substantial adjustments to its tentative ranges. That course of action would seem to be at least as warranted in mid-1990 as it was a year ago, given the uncertainties about fiscal policy as well as about developments in financial markets and their effects on money velocity. The drawback to this approach is that it might not be viewed as within the spirit of the Humphrey-Hawkins exercise, which called for monetary ranges for the coming year in July so that Congress could get a clearer view of the Federal Reserve's intention over a slightly longer time horizon. Before 1989 the Committee had announced different ranges for the upcoming year than were in force for the existing year in 8 out of 10 years.

But retaining the 1990 range--assuming it is unchanged--for 1991 might be justified on policy as well as uncertainty grounds. If fiscal policy were to tighten substantially, growth in the upper portion of the current M2 range might be needed to foster the Committee's objectives for the economy and prices. Monetary policy also might have to ease interest rates appreciably if it appeared that credit availability problems were exerting a greater degree of restraint on spending than consistent with the Committee's objectives. In these latter circumstances, however, the lower interest rates might not boost M2 growth as much as suggested by historical relations, because banks--not wanting additional funds to make more loans--could drop offering rates quickly in response to lower market rates, keeping opportunity costs high. Still, if the credit crunch were a major concern, not reducing the range might more accurately convey the impression that the Federal Reserve was prepared to combat its effects with a more accommodative monetary policy.

A potential difficulty with not reducing the M2 range is how it would be read relative to the Federal Reserve's price stability objective. The current range would be consistent with the easier 5-year strategy in that it provides more scope to lean promptly against any tendencies for the economy to soften appreciably, leading to a tendency for inflation to accelerate. A set of more rapid money growth ranges was not included among the alternatives for 1991 because the current ranges would encompass the easier strategy, even in the absence of a significant further velocity shift.

A downward adjustment of the M2 range for 1991 could be seen as more consistent with some restraint on spending and prices. A half point reduction to 2-1/2 to 6-1/2 percent would center this range around the staff outlook consistent with the greenbook forecast; a full point reduction might be considered consistent with even more emphasis on bringing down inflation, as under the tighter strategy II. Absent a continuing velocity shift, however, M2 growth would be expected to be around 6 percent under the baseline, about in line with the growth in income, since no change in interest rates is projected. Thus any downward adjustment to the M2 range depends more on the velocity shift than it does on the restraint implied. In these circumstances, the odds are even greater that at some point in the future the M2 range would have to be increased, to deal with the return to more normal changes in velocity as well as the surge in money demand as nominal interest rates drop with disinflation.

With regard to the M3 range, the Committee faces essentially the same problems and choices for 1991 as were discussed for 1990. If the range were left unchanged in 1990, it could be carried over to 1991 with the same sorts of explanations about the possibility of shortfalls depending on the course of thrift restructuring next year. The range could also be reduced, as in the suggested alternative of 0 to 4 percent, to more closely encompass the Committee's best guess about an outcome for next year consistent with its policy intentions. This would seem especially appropriate if the Committee also lowered the 1990 range.

An unchanged debt range from 1990 to 1991 would be consistent with leaving other ranges unchanged, if the Committee chose to do so, and in addition might convey the Committee's concerns about the adequacy of credit flows. On the other hand, even reducing the range to 4 to 8 percent allows for very high debt growth. The center of that lower range, at 6 percent, is about in line with nominal income. Growth of debt at this rate might be viewed as a welcome development, implying more sensible leverage and more stable debt burdens, which the System might want to endorse.

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SHORT-RUN POLICY OPTIONS
Donald L. Kohn

The issue facing the Committee as it views its near-term policy options seems to be whether conditions warrant staying with the current stance of no action, going to an immediate easing, or to something in between in the form of a strong predilection toward ease over the intermeeting period.

Financial market indicators are giving mixed signals as to the outlook for the economy and policy. Most prices in financial and closely related markets do not suggest that policy is obviously too tight. Real interest rates in both long and short-term markets, though above lows of last year, are well below earlier peaks. Our measure of the real corporate bond rate is close to estimates of the average level of the equilibrium real rate over the last decade or so. The equilibrium real rate undoubtedly varies somewhat over time, but actual real rates close to the current equilibrium would imply an economy with fairly stable inflation rates and also one in which weakness--or strength--in activity was unlikely to cumulate for very long, absent a push from another source. Perhaps reflecting this sanguine outlook, stock prices are near record levels and price-earnings ratios are relatively high. The foreign exchange value of the dollar is in the lower portion of the post-Louvre trading range, which does not suggest monetary stringency, at least relative to conditions abroad, and commodity prices outside of gold and oil are up on balance this year.

Of course, real interest rates in markets may be understating the degree of restraint on spending from credit market conditions if part of that restraint is coming from increases in administered lending rates, tighter nonprice terms and simple unavailability of credit for borrowers without access to open credit markets.

Monetary restraint from this source would not necessarily be inconsistent with the behavior of the stock market or dollar if these markets saw the restraint as appropriate--or they anticipated a timely easing by the Federal Reserve. However, expectations of such a policy move are not built into the yield curve. While markets seem to think there's a greater chance that policy will ease before it tightens, they have not built a significant relaxation of policy into their expectations. For the near-term future, expectations of little change in policy could reflect a reading of the Federal Reserve's predilections from the lack of recent policy actions and press reports. But this would not explain the relatively flat slope of the yield curve further out, which suggests a market outlook for interest rates remarkably close to that of the staff.

Information on credit conditions and the behavior of assets and liabilities at depository institutions, however, may be giving cautionary signals about the effect of financial conditions on the economy, though they need to be interpreted especially carefully. Monetary aggregates have been much weaker than expected, as we have already discussed. A great deal of this weakness in M2 and M3 we believe to have few implications for the economy and spending. For M2, perhaps the more puzzling of the aggregates, the runoff of high-yield, interest sensitive money from thrifts as they were resolved or cut back most likely has little significance for economic activity. And, to the extent the weakness in M2 owed to unattractive offering rates spurred by a drop in depository assets of the sort easily securitized, the public's liquidity on the one side, and the terms on which it borrowed on the other, would be affected only a little. But some of the weakness in M2 apparently has reflected a shortfall in spending relative to projections, and some could portend future softness in the economy if it resulted from a constriction on credit to some borrowers who lacked easy access to market credit directly or through securitization of their loans.

Some of this clearly is going on, even outside the real estate and LBO areas. Many small businesses apparently are facing tighter nonprice terms and a small rise in loan rates relative to the federal funds rate. The rate increases aren't much--perhaps 25 basis points--and the spread of the loan rate relative to the funds rate is within historical standards. Still, the wider spread does tend to confirm some pulling back of credit by bank lenders. The quantitative significance of this is hard to evaluate. Business borrowing from banks has been weak for well over a year, abstracting from merger-related lending. Data for June suggest a modest strengthening of C&I loans at banks--though further weakness in real estate and consumer loans. For the second quarter, we are estimating some strengthening of business debt growth, as investment-grade borrowers step up bond issuance.

Of course, restraint on credit may be evident only with a lag. As Mike noted, some such restraint is built into the greenbook forecast. In that forecast, we are expecting a modest pickup in M2 growth over the third quarter, but only sufficient to keep this aggregate in the lower half of its range, as the RTC remains active and banks keep credit growth moderate. Week-to-week changes in M2 are particularly difficult to predict and interpret, since they depend in part on the pattern of RTC activity and the reaction of the depositors and purchasing institutions. We have built into our path some near-term weakness of M2, owing to the burst of RTC spending in the days just before quarter-end, and as a consequence this aggregate could approach the lower end of its 3 to 7 percent growth cone before strengthening somewhat. With thrifts continuing to shrink, M3 growth is expected to be especially weak--perhaps around 1 percent over the third quarter.

Alternative A, or some lesser easing of policy, would seem to connote a judgment that effective restraint on the economy, signalled in part through the aggregates and the shrinkage of depository intermediation, was creating too big a risk of an unacceptable slowing of output or even a recession. An easing now could be viewed as a form of insurance, reducing the odds on recession if the credit situation is worse than now seems apparent.

Unless upcoming data show some bounce in economic activity, it seems likely that policy easing would reduce long-term as well as short-term interest rates, and the dollar exchange rate as well. It may be that, in light of the situation at depository intermediaries, the price or availability of credit extended and held by those institutions would not change as much as usual when policy was eased--the so-called pushing on a string syndrome. As a consequence, the extent of the economy's response to an easing might be muted to a degree. But that degree should be small. As the role of depositories as holders of credit diminishes in financial markets, so too does the importance of their particular response to lower or higher interest rates in the channels of policy influence on the economy. At the same time, the increasing proportion of borrowers having direct or indirect access to open credit markets--including household mortgage and credit card borrowers--and the growing proportions of spending and production in foreign trade, suggest no decrease and perhaps some increase in the power of lower interest and exchange rates and higher asset values from easier policy to stimulate spending.

Alternative B might be considered a holding action to await more definitive indications of the underlying state of the economy and financial markets. Not only the employment data of this Friday, but the PPI and retail sales of next Friday might be of special interest at this time, along with the weekly money and credit data. If there were particular concerns about down-side risks, a tilt in the intermeeting language of the directive would signal the Manager to be especially alert to the possibility the policy should be eased in response to indications in the data that the economy was soft or financial conditions tightening.